MEET THE ROUNDTABLE

JOSEPH MARKS
CAPITAL DYNAMICS
Marks is a managing director and head of secondaries in investment management. He has 16 years of experience in private equity and has previously been responsible for secondary portfolio transactions at Coller Capital in New York.

TODD MILLER
COGENT PARTNERS
Miller is a managing director and is primarily responsible for coverage and execution of secondary private equity transactions for North American clients. Prior to joining Cogent Partners in 2005, he spent several years in traditional investment banking, primarily with Credit Suisse First Boston.

ROBERT SHANFIELD
LANDMARK PARTNERS
Shanfield is a partner and leads the secondary private equity business. He has been with Landmark since 1998, prior to which he spent 10 years at GE Capital, where he was a senior vice president in GE Capital's equity capital group, responsible for originating and managing private equity investments in the US and Europe.

SECONDARIES

Getting complicated

Buoyant capital markets and LPs looking to take money off the table have helped keep secondary activity levels high, but could a public market correction bring deal flow to a halt? Graham Winfrey sat down with six industry experts to find out what to expect from the rest of 2014

***PEI:* What surprised you about the secondaries market in 2013?**

Todd Miller: What surprised us was the amount of one-off volume transacted, including large proprietary deals. We all knew that clients had single positions and they were being traded if someone found a good price, but it was the number of transactions and the amount that surprised us. This was a part of the market we weren't actually aware of last year.

Joseph Marks: We actually also saw a couple of cases including a transaction we did where the ground rules set out by the seller dictated that only existing investors were invited to participate. Additionally, only dedicated secondary buyers, so no non-

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traditional buyers, were allowed to bid. The seller wanted a counterparty that would bring a lot of certainty to the process – even at the expense of making a price concession in exchange for that certainty.

Adrian Millan: What surprised us was the diversity of participants. That shift really manifested itself last year when the top ten holders of committed capital were no longer the only dominant forces in the market. Sovereigns and opportunistic LPs have changed the rules of engagement and how you bring large deals to the market.

David Tegeler: We've always handled end-of-fund-life issues for our sponsor clients and have at times struggled to align interests. For us, 2013 was the year where that work started to spill over into the secondaries area, as established secondary firms provided outside capital for fund restructurings or recaps. While the number of these deals that actually close is relatively small, it is a course of action considered by many fund clients. This is a trend that has continued to gather momentum in early 2014 and we feel that these deals are not going away any time soon.

David Wachter: From our perspective, the challenge in this past year has been the significant market price movement. This is causing a lot of price discovery discussions and situations where sellers are highly sensitive to fair market value and discounts. In direct secondaries, there is no concept of NAV »

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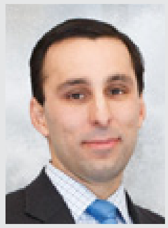

ADRIAN MILLAN
PARK HILL GROUP

Millan is a managing director at Park Hill Group, a specialised secondary advisor. Prior to joining Park Hill in 2009, he was a director with Citigroup Alternative Investments, where he led secondary transactions and business development initiatives. He has 14 years of experience and previously worked at JP Morgan Chase.

DAVID TEGELER
PROSKAUER

Tegeler is a partner in the corporate department and co-head of the Global Private Investment Funds Group. He concentrates on representing private investment fund sponsors, secondaries firms, institutional investors and industry advisors in fund formations, buy and sell side secondary transactions, restructurings and governance issues.

DAVID WACHTER
W CAPITAL

Wachter is a founding partner of W Capital Partners, which provides private equity shareholders with liquidity for their investments. Prior to founding W Capital in 2001, he held senior roles as an investment banker and private equity investor at Lehman Brothers and Jefferies.

PHOTOGRAPHY BY: Mark Byron

> *You can't get worked up over one or two quarters. It's a longer game than that*
>
> Joseph Marks

» and discounts to NAV, so pricing is based on dollar valuation views of the buyer and seller. In order to find opportunities where we can get transactions done, it requires more rifle-shot-oriented situations where there's an ideal fit in seller objectives and buyer appetite.

What has happened to pricing so far in 2014? And how has public market sentiment affected willingness to sell?

TM: One of the challenges we have as an advisor is [that] sometimes we're guiding someone months before they actually hit the market. So you pick a time like right now. The last couple of months have been really challenging because you've been marketing off September 30 marks. So everybody's hearing these fantastic prices, like the 20 percent and 30 percent premiums for some of the quality funds. That actually was happening, off September 30. And we all know that Q4 was strong. But what happens is [that] those numbers get in CIOs' heads and private equity professionals' heads, and then the reality is they're not going to mark it off September 30. Now the December 31 marks are coming out. Those marks are up – and they still want premiums off of the year-end marks. So we always have a challenge of trying to set expectations. But we are still seeing quite a few funds trading at premiums [from] year-end [values].

AM: A big driver of activity thus far in 2014 has been LP sellers looking to take money off the table in funds with public exposures. They like where the capital markets are today, and their preference is to crystallise returns – not because they need to, but because they question the remaining uplift in the underlying public securities that are in these funds.

DW: Private sellers' willingness to sell in a secondary transaction tapers in a market environment where access to capital is easy and the perception of available liquidity is high. Buyers, on the other hand, have to be careful. You have to pay for quality.

JM: What was a little surprising was how well 'mixed quality' portfolios of assets traded, which further requires, in our view, more of a focus on asset and manager selection. The larger portfolios seem to be getting stronger pricing than I would have expected given the mixed quality and maturity of assets.

With relatively few large portfolio deals on the market, what are the benefits and disadvantages of scale?

DT: Several secondary funds have closed on a substantial amount of capital over the last few years, and those firms certainly have an advantage when convincing sellers that they will be able to quickly and effectively execute on large portfolios. While smaller portfolio deals certainly attract broader interest and increased pricing competition, they also involve fewer counterparties, which can help expedite and simplify the signing and closing process.

TM: When I started this nine years ago a \$75 million deal was a nice-sized deal, and that's pretty small these days. It's probably migrated to \$200 million to \$250 million. That's a nice, average-sized deal. I can think of two clients that are contemplating doing \$500 million or greater transactions very seriously. Strong pricing is driving almost all of those discussions. So I think actually you're going to see some large transactions this year. We've already seen some. Every LP keeps saying they have too many managers and too many relationships – even the »

» ones who've done two, three or four sales. Everyone has too many managers, and it's only exacerbated by the length of the funds or the time it's taking funds to wind up. There's a fund in the market with a 15-year term on their newest fundraise. We hear that 15 years is more the norm. It's not ten years plus some one-year extensions. 15 years is actually the median.

JM: Another statistic is that less than 10 percent of funds actually do wrap up within their stated legal life. There's still going to be opportunity over the years. You can't get worked up over one or two quarters. It's a longer game than that.

Did any of the big people moves in the advisory community last year have an impact on the market?

AM: Despite the moves that took place, we did not see an impact on market volumes. There will always be new and changing players in any growing marketplace.

Robert Shanfield: The other thing that we've seen happen in the advisory market is the growth of this sort of buy-side engagement. The matching of individual interests buyers have in a specific LP interest with a corresponding interest of an existing LP to sell. It's not clear to us how much this activity is taking from transactions that would otherwise have been intermediated in sell-side engagements, or whether it is adding or detracting from overall pricing efficiency in the market. I think there are arguments on both sides. But there's no question the economics are better for the advisors.

TM: The economics are fantastic. Actually better than our market. There are people popping up everywhere trying to do this. I don't think it had any impact on the market last year. Just three years ago the advisor space was a duopoly. Every pension fund we went to said we're only interested in talking to two advisors. Now it's not uncommon for us to show up and someone says, 'I've been interviewing five or six advisors'. And that's just in the US.

DW: To me it's just a general recognition that the breadth of the secondary market is getting much more significant, and the industry is justifying more advisors than it has in the past. In the plain vanilla LP interest transactions, from what I understand, the fees are getting compressed, leading advisors to look to pursue advisory work in the more difficult and creative parts of the market, such as fund recaps. The other interesting thing is that no large investment bank has moved in to be a major player in this market. In fact, it's gone the other way, where guys have left bigger firms to start small, more specialised boutique shops. This may be because the overall fee base of the industry is not material for a big firm.

Where is the best value to be found? And to what extent are investors branching out into other types of private market secondaries, particularly via separate accounts with blended strategies?

AM: The best opportunities are where access is limited, underwriting is difficult, structuring is possible or specific expertise is required. Given these dynamics, there has been a meaningful uptick in GP recapitalisations as well as interest in real estate, energy, credit and infrastructure secondaries. »

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>
> **David Wachter**

» **JM:** I think if you're putting money in secondaries in the next three to five years you need to have a longer view and not look at only this quarter and last quarter.

Personally, I think there will be just as good a chance at buying at better entry values today than the other way around.

RS: We've been doing real estate secondaries for 20 years. It's a market that in a lot of respects parallels private equity, albeit with a timing lag. And it's a really interesting place to be. We all look back at the old days of private equity secondaries, when there were fewer competitors and better economics at the individual transaction level. However, there was much less going on and the market needed a lot of education. I think where real estate is right now is somewhere in the midst of a similar evolution.

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>
> **David Tegeler**

DT: We've been anticipating an increase in secondaries activity in Asia. As a result, we've recently hired attorneys in our Beijing and Hong Kong offices with experience in both private investment funds and secondary transactions. With respect to private equity real estate secondaries, that does feel like something that's been delayed. The volume appears to be increasing, however, and it could have a big impact in the secondaries market going forward.

There's been a lot of talk about the restructuring of zombie funds. What are the particular challenges involved here?

RS: These restructurings aren't necessarily inextricably tied to what are referred to as 'zombie funds'. There are basically a lot of these funds late in their life that are candidates for restructuring and it can be very sensible. They are not all characterised by this walking dead.

> ***Nine years ago a $75 million deal was a nice-sized deal, and that's pretty small these days***
>
> **Todd Miller**

DW: The term zombie fund is popular but it's not really what's going on in the marketplace. There is a significant difference between the zombie *fund* and the zombie *firm*. The marketplace is about hundreds of funds that are beyond year 10. Most of these are simply mature funds being managed by ongoing firms that have successor funds, »

» healthy fee streams and stable employee bases. Eight out of 10 of these mature funds are managed by GPs that are capable of managing those assets out to exit. How all of those mature zombie *funds* are going to be dealt with and exit their unrealised investments is a much bigger market than the zombie *firm*. It's the two out of 10 firms that don't have a future opportunity to raise a new fund that are considered zombie *firms*.

Every week we get a call from a GP who is not going to raise a successor fund and is looking for financing to do new deals and someone to buy out their old LPs. A limited number of those firms will get recapped. Also, if you actually look at the recaps that have been done to date, which is just a handful, the results of those have been mixed. We don't see the fund recaps as a broad solution to the real zombie issue in our market. Eventually, all the assets will have to be sold.

TM: Don't underestimate the mindset of the LPs. In most of these situations the GP hasn't performed and the LPs aren't particularly thrilled. So the whole perception that they may be extracting anything at the expense of the LP selling makes this very tricky.

DT: The name 'zombie fund' has clouded the conversation to such a degree that we don't use the term at all. At Proskauer we call them "tail-end funds". We certainly agree that these deals can be quite complicated, and it's important for secondary firms to understand the nuances and, together with the fund sponsor, ensure that there are appropriate economic incentives for all participants in order for the restructuring to be successful. Many of these deals include options for existing LPs to sell to secondary firms, "roll over" their interests into a new partnership, and/or opt to provide follow-on capital alongside the participating secondary firms, which provide existing LPs [with] a menu of options. Also, the LPs are smart and take what they learn through dealing with end-of-fund-life situations and apply it to their primary investment activity. For example, it wouldn't be surprising to see funds with an initial term of more than 10 years become more common.

AM: End-of-life funds are the most challenging transactions, as there may be issues with both the GP and the assets. Mid-life fund recapitalisations with viable remaining assets often provide for a better transaction environment for all participants. The historical relationship between the GP and their LPs, good or bad, can have a meaningful impact on the outcome.

JM: I call it a three-ring circus. You've got to deal with the LPs, the GPs, and the buyer. And you have to [find] that narrow intersection where those three circles come together in the Venn diagram, and that is tricky. If you don't have a good idea of where that spot is, you can end up wasting a lot of time.

How prevalent and/or sensible is the use of leverage to boost returns for secondaries funds?

AM: It's very prevalent at the upper end of the market. There are many banks that are looking to provide this type of financing. How leverage is used is very different across the buyer universe, but it is being actively employed and in many of the cases where larger deals are getting done, it is a large component of the conversation.

> ***A big driver of activity thus far in 2014 has been LP sellers looking to take money off the table in funds with public exposures***
>
> **Adrian Millan**

> ***Real estate secondaries [is] a market that in a lot of respects parallels private equity, albeit with a timing lag***
>
> **Robert Shanfield**

TM: It's prevalent and it's cheap.

RS: It's more prevalent than it is sensible. Not to say that it's not sensible—in many cases it is. But I think we're getting to a point where some amount is becoming harder to see as sensible.

JM: I think the cost of capital point is critical. As the market evolves there needs to be a proper cost of capital lined up with the proper secondary market products. It's important to note that there are LPs who want to seek strategies that don't employ leverage, so there's diversity among LP appetite for risk.

Will 2014 see the upward trend in the market continue?

RS: Volume has been pretty steady in the $25 billion [region] each year for the last three years. I think a risk is that there's a more dramatic fall off in the public markets, creating dissonance that really causes people to sit back and feel more alienated from the environment we've just come from, and stand still for a quarter or two. That said, I think that is a low probability. A relatively stable public market environment combined with a growing pool of unrealised NAV and some clearer, more tangible pressures from the Volcker rule all bode well for volumes at or above recent years' levels.

TM: From our perspective, absent any shock in the market, we can absorb a 5 percent or 10 percent decrease. I don't think it really changes the dynamic. But we still believe this is going to be a pretty decent-sized year. We thought it could grow double digits this year, and where are we seeing that? It's the broadening of the market, so this whole restructuring and directs space we see continuing to grow. We think it could be 25 to 30 percent of the market in 2014. And more asset classes. We're doing more real estate and infrastructure right now than we've ever done.

JM: We are already seeing more complexity at the small end of the market. There's been a perception that only big deals are complex, and they certainly can be. But we've already done a number of small transactions this year where, for unique reasons inherent in each transaction, it's not a plain vanilla deal. So one trend that I predict will continue is complexity around end of life solutions at the small end of the market – both individual funds as well as funds of funds. Separate accounts also fall into that bucket.

DT: We believe there will definitely be a flight to quality in 2014 and beyond as LPs and GPs seek out high-quality advisory firms and law firms that are able to execute on very difficult and intricate transactions. We are spending a lot of our time recently on fund restructurings and fund recaps. With over 350 GP clients and over 100 LP clients, it's naturally become part of the landscape for us. We also see the potential for increased secondaries activity in Asia in the coming years.

AM: I do think that all of us collectively across the market – not just around this table – have concerns about how sustained this very nice runway for getting deals done will be into 2014. I think we'll have a very strong second quarter, and with continued stability or growth in the capital markets, we would expect 2014 to be a record year. ■